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Economic Outlook

Irving Trust

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The evidence continues to mount that economic growth is accelerating from the sluggish pace of the first half of this year. We expect the annualized growth rates for real GNP in the third and fourth quarters of this year and the first two quarters of next year to average about 4%, compared to increases of 0.3% in the first quarter of 1985 and 1.9% in the second quarter. On a fourth-quarter to fourth-quarter basis, real GNP is expected to rise 2.7% in 1985 and 3.3% in 1986.

The Administration's "flash forecast" for real GNP in the third quarter was an annualized growth rate of 2.8%, but it now appears that the economy grew at a faster pace. To a considerable extent, the improvement in the third quarter was due to a surge in auto sales and a narrowing of the trade deficit. Both of these developments could well be reversed in the fourth quarter, although it will still be necessary to rebuild auto inventories. More fundamentally, however, steps have been taken during the past year that should lead to an improvement in economic growth, and we are finally beginning to see some results. Money market rates are still roughly 350 basis points lower now than the levels reached in the summer of 1984. Inventories have been brought into better alignment with sales, and the dollar has come down substantially from the levels reached earlier this year. All of the developments could be expected to foster a pickup in economic growth, though with varying lags.

Despite this favorable assessment that real growth is accelerating, the general improvement in the pace of economic activity will probably not be felt soon by several important industries currently undergoing painful adjustments. In last month's Outlook, we noted that manufacturing employment finally increased in August after declining steadily since the beginning of this year. Partly due to the continuing troubles in the high-tech industries, manufacturing employment fell sharply in September to the lowest level since early 1984. Nevertheless, one sensitive barometer of the employment situation, initial claims for unemployment compensation benefits (which is one of the components of leading indicators), has remained surprisingly subdued for the last few months at relatively low levels.

A frequently cited potential damper on consumer spending is the substantial amount of installment debt incurred during this recovery period. Installment credit outstanding in August reached a record 18.9% of income after taxes. As consumers place commitments on future income, they limit their ability to maintain their past rate of spending. If anything, the situation in terms of consumer indebtedness may be worse than the numbers show, since home equity lines of credit, which are not included in the installment credit data, have been promoted aggressively by many financial institutions. Nevertheless, merely based on the demographic structure of the population today, with the "baby boomers" having such an important position in the marketplace, it should be expected that consumer indebtedness would be at a record level relative to income. A heavy overall burden of consumer debt may indeed act as a retardant on consumer spending in the future, but it will not be the critical factor that will eventually induce a recession.

Bernard Schoenfeld

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Economic Forecast

Percent Changes at Annual Rates

	Actual		1985		Forecast 1986				Actual 1983-	1984-	Forecast 1985-
	I	II	III	IV	I	II	III	IV	1984	1985	1986
Gross National Product	5.6	4.5	7.1	8.3	7.3	8.3	7.7	7.3	10.8	6.4	7.5
Real GNP	0.3	1.9	3.9	4.7	3.8	3.8	3.0	2.5	6.8	2.6	3.7
GNP Price Deflator	5.4	2.6	3.1	3.5	3.4	4.3	4.5	4.7	3.8	3.6	3.7

	Actual 1985: II	Forecast 1985:III	Actual 1983-1984	1984- 1985	Forecast 1985-1986
Consumer Spending	7.8%	8.3%	8.6%	7.4%	7.6%
Durable Goods	5.4	24.7	13.9	8.6	6.0
Nondurable Goods	6.8	1.2	6.9	4.1	5.6
Services	9.2	9.2	8.5	9.5	9.4
Business Capital Spending	15.4	6.9	20.6	10.4	8.8
Structures	13.9	10.0	16.0	13.2	9.1
Equipment	16.2	5.2	23.4	8.9	8.7
Residential Investment	7.4	7.0	16.4	3.4	0.6
			1984	1985	1986
Change in Inventories	$17.9b.	$-7.0b.	$58.2b.	$17.4b.	$38.8b.
Net Exports of Goods and Services	$-94.0b.	$-85.0b.	$-64.2b.	$-86.6b.	$-109.8b.
			1983-1984	1984-1985	1985-1986
Government Purchases	9.9%	11.2%	9.0%	9.8%	7.6%
Federal	5.5	15.2	9.5	11.6	5.7
Defense	12.9	8.8	10.5	9.6	7.1
Other	-12.0	35.0	6.7	17.7	1.8
State & Local	13.1	8.6	8.7	8.6	8.9
Corporate Profits Before Tax	-10.2*	2.1*	16.0	-3.1	8.1
Corporate Profits After Tax	-8.5*	-0.1*	14.5	-3.5	8.2
Plant and Equipment Expenditures	19.2	4.2	16.3	9.2	8.1
Real Final Sales#	4.6	6.0	5.0	3.6	3.1
Real Disposable Personal Income	8.2	-3.9	6.7	2.2	2.7

Economic Indicators	Recent Data July	Aug.	Sept.	Actual 1983-1984	1984-1985	Forecast 1985-1986
Consumer Price Index**	2.4%	2.4%	n.a.	4.0%	3.8%	4.3%
Producer Price Index for Finished Goods**	3.6	-3.6	-7.2	1.7	1.3	3.3
Industrial Production	0.0	3.6	n.a.	11.5	2.6	3.6
Retail Sales##	0.2	2.8	2.7	10.5	7.0	4.7
				1984	1985	1986
Auto Sales (millions of units, a.r.)	10.3	12.6	14.5	10.4	11.2	10.4
Housing Starts (millions of units, a.r.)	1.65	1.75	n.a.	1.75	1.73	1.64
Unemployment Rate	7.3%	7.0%	7.1%	7.5%	7.2%	6.9%
Merchandise Trade Deficit (a.r.)	$126.1b.	$118.8b.	n.a.	$123.3b.	$147.0b.	$170.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

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#GNP less change in inventories, both in real terms.
##Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December to December (not seasonally adjusted).

$b. = billions a.r. = annual rate F = Forecast